No. 12144

In the United States Court of Appeals for the Ninth Circuit

HOFFMAN RADIO CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

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OPINION BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 21-46) are unreported.

JURISDICTION

This petition for review (R. 551-555) involves federal income, declared value excess profits, and excess profits taxes for the taxable year 1943. On May 9, 1946, the Commissioner of Internal Revenue mailed to the taxpayer notice of deficiency in the total amount of $55,945.35. (R. 9-19.) Within 90 days thereafter and on July 31, 1946, the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 4-8.) The decision of the Tax Court modifying the deficiency was entered September 22, 1948. (R. 47.) The case is brought to this Court by a petition for review filed November 30, 1948 (551-555), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

QUESTION PRESENTED

Whether the Tax Court properly determined the maximum reasonable amount that may be claimed for salary expenses under Section 23 (a) (1) (A) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations involved are to be found in the Appendix, *infra.*

STATEMENT

The facts as found by the Tax Court may be summarized as follows:

Taxpayer, a California corporation, was incorporated in 1932 under the name of Mission Bell Radio Mfg. Co. Its name was changed in 1943 to Hoffman Radio Corp., without altering the continuity of its corporate existence. (R. 22.)

From 1932 to 1942, taxpayer was principally engaged in manufacturing commercial radio receiving sets, but this manufacture was restricted and finally prohibited by a general order of the War Production Board issued March 7, 1942, effective April 23, 1942. (R. 486-487.) In 1942 taxpayer was engaged in manufacturing radio and electronic equipment. Sales of commercial radios constituted 31.61 per cent of its total sales; sub-contracts on Government orders constituted 65.24 per cent; experimental work constituted .15 per cent. Its 1943 sales were chiefly related to Government contracts and orders, 99.96 per cent. The remaining .04 per cent related to commercial sales. (R. 22.)

From the date of incorporation to 1941, inclusive, taxpayer's operation was as follows: It sustained net losses in 1932, 1933, 1939, 1940, and 1941; it realized net income in the years 1934 to 1938. (R. 22.) A table of comparative profit and loss statements for the years 1940 through 1943 may be found at pages 23 to 25 of the printed record.

In July of 1941, H. L. Hoffman became interested in acquiring control of taxpayer. He thoroughly investigated its affairs. In October or November of that year, he interested G. Gifford Davidge and Walter D. Douglas in a plan to acquire stock and management control. Davidge and Douglas were both men of ample means, and were conversant with taxpayer's affairs and reputation in the industry. They were both experienced in the radio and electrical business and had experience in the statistical and financial phases of the security investment business. Hoffman was not, and is not now, related to Davidge and Douglas, nor was he acquainted with them when negotiations commenced for the acquisition of taxpayer. (R. 26.)

Evidenced by formal documents subsequently drawn by Davidge's attorney, Hoffman, Davidge and Douglas entered into an agreement concerning terms and procedures for acquiring control of taxpayer. Hoffman was to contract to purchase, on an installment basis, all the stock of taxpayer, and to hold the stock interest so acquired as trustee for himself (50 per cent interest), Davidge, and Douglas (25 per cent each); each of the parties was to become a director and officer of taxpayer; Hoffman was to be employed as general manager at a fixed salary later to be agreed on, plus an incentive compensation in a monthly amount equal to three per cent of the monthly gross sales; each was to loan capital to the taxpayer, the majority of the lenders to be entitled to determine the use of the money; if at any time any two of the three should determine that taxpayer could not be successfully operated, Hoffman was to make no further payments on the stock and the trust was to terminate. (R. 26-27.)

Prior to December 1, 1941, taxpayer's stockholders were: H. G. Schmieter, 110 shares; Franklyn and Helen E. Warner, 193 shares; P. L. Fleming, 110 shares. (R. 27.)

By separate written agreements of December 1, and December 4, 1941, Hoffman agreed to purchase all 413 shares of outstanding stock, for the sum of $11,755, to be paid in installments. The December 1 agreement (R. 489-498) between Hoffman and Schmieter provided in part for Hoffman's employment as general manager, pending payment in 36 months for the stock, to be paid three per cent of taxpayer's gross sales. (R. 27-28.)

Under this agreement, Hoffman was to receive all dividends, except in case of his default. A new certificate for the 110 shares held by Schmieter was to be issued to Hoffman, then endorsed to Schmieter as collateral for payment. (R. 28.)

On December 4, 1941, Hoffman made a substantially similar agreement with the Warners (R. 498-506), except that he was also to receive three per cent of the gross sales each month and in addition such an amount as from time to time might be agreed upon between Hoffman and taxpayer. On the same day, Hoffman entered into an agreement with Fleming (R. 507-517) substantially similar to that with the Warners. Fleming further agreed not to take action against the taxpayer for unpaid back salary until January 15, 1943, at which time a further extension would be agreed upon provided taxpayer was then unable to pay dividends on its stock aggregating $1,500. (R. 28-30.)

After Hoffman acquired Schmieter's stock, he became a director. At a directors' meeting December 4, 1941, the directors being Hoffman, Fleming, and one M. E. Penney, Hoffman was employed as general manager of taxpayer, the terms of the agreement being set forth in an instrument dated December 4. (R. 539-541.) The agreement provided for payment to Hoffman of three per cent of all gross sales as partial payment for his services, additional compensation to be paid in "such other amounts as may hereafter from time to time be mutually agreed upon." The agreement was for 36 months, but terminable by Hoffman after February 28, 1942. After the approval of his employment contract, Hoffman advised the board that he had negotiations pending to acquire the remaining stock of taxpayer, a half-hour recess was called, and Hoffman acquired the remaining stock during the recess. The meeting reconvened and upon proper motions, Davidge and Douglas were substituted as directors for Fleming and Penney. (R. 30, 531-535.)

On December 9, 1941, Hoffman, Davidge, and Douglas executed a contract setting forth the agreement of the parties to advance monies to taxpayer; that such parties were to be directors; that Hoffman was to be president and general manager and receive three per cent of gross sales as part compensation; that Davidge was to be vice president, Douglas secretary-treasurer; that Hoffman's stock rights were to be held in trust for the three men, 50 per cent eventually to belong to him, 25 per cent each to Davidge and Douglas. (R. 30-31, 517-525.)

Rather than start a new company, Hoffman, Davidge, and Douglas found it necessary to rehabilitate the old, since its principal asset was a license from R. C. A., one of the stipulations of which was that it could not be sold or transferred. (R. 31.)

The minutes of a board meeting on May 15, 1942, show discussion of the need for expanded plant facilities, and setting of Hoffman's salary at $800 per month, among other things. (R. 32-33, 535-538.)

When Hoffman became manager of taxpayer, its physical plant and equipment were small and obsolete. It had no productive staff, the employees consisting of its then president, an office girl, and a stock boy. In 1942 the highest number of employees was 107; in 1943, 297; in 1944, 351. The taxpayer's plant was greatly expanded, from rented quarters of 7,500 square feet in 1941 to a plant area of 40,000 square feet in 1943, including a building bought by taxpayer for approximately $55,000, the $25,000 down payment on which was made from funds advanced by Hoffman, Davidge, and Douglas. (R. 33-34.)

Salary and bonus payments and stock ownership of three of taxpayer's officers were as follows (R. 34):

Name and Office	Salary and Bonus 1942	1943	Percentage of Stock Owned
H. L. Hoffman, President and General Manager	$18,688.52	$63,613.20	50%
R. A. Yarcho, Secretary	2,483.25	5,762.26	None
Walter S. Harmon, Vice President and Engineer	7,244.18	22,171.08	None

Taxpayer was located in a number one labor area, which made it difficult to obtain contracts from the Army and Navy. Hoffman was, however, instrumental in forming the West Coast Electronic Manufacturers Association, which contributed substantially in helping smaller companies to secure war contracts. Taxpayer was awarded the Army-Navy E in 1944, on recommendation of the Navy. (R. 34.)

Taxpayer negotiated a loan in September of 1943, the loan agreement providing in part that no further dividends could be paid without the prior consent of the bank. (R. 34, 399-413.)

Hoffman, 38 years of age, held a Bachelor of Arts degree (1928) from Albion College, Michigan, having majored in business administration and philosophy. From 1928 to 1941 he worked with various firms and was also from time to time in business for himself. In 1941 he made $13,000 per year from the Peerless Electrical Manufacturing Company, paying his own expenses. Previously, his annual income had been considerably lower, showing generally a gradual increase from 1928 on. (R. 35.) During this period he gained experience in practical factory and machine work and methods; supervision of factory production and personnel; merchandising; developing distributor organizations, sales programs, and service organizations; training factory and sales personnel; coordinating sales programs and factory schedules, and salesmanship. Part of his experience was electrical, including radios and fluorescent lighting. (R. 35.)

He was the only salesman and business solicitor employed by taxpayer in 1942 and 1943, obtaining war contract orders of $4,382,050.13 in 1942, $881,244.81 in 1943. Production under these contracts was not confined to the year they were obtained. He was also in charge of personnel, and observed a 14-to-16 hour day. Taxpayer had no Washington, D. C., representative in 1942 and 1943. (R. 35-36.)

The type of war contracts obtained and performed by taxpayer in 1942 and 1943 required the exercise of managerial, engineering, and mechanical skill, and inventiveness in design, production, procedures, tooling, testing equipment, and the efficient use of, or substitution for, materials which were critically short in supply. Many of the orders were of a type not solicited by comparable companies, or orders in the performance of which other companies had failed. The major war products manufactured in these years were frequency meters, variable condensers, antenna kites, phantom antennas, noise peak limiters, and electronic relays and firing error indicators. (R. 36.)

The Continental Radio and Television Corporation, which was succeeded by the Admiral Corporation, was engaged in the business of radio manufacture at Chicago, Illinois. In 1942 it had total net sales of about $7,500,000, and in 1943 it had total net sales of about $14,149,513. It had a net profit, after paying salaries and before payment of taxes, for 1943, in the amount of $1,098,633. All of its 1943 business was from Government orders. The salaries of its officers remained the same in 1943 as they were in 1942, for which years they were substantially as follows: President, $50,000; vice president, $35,000; vice president, $30,000; treasurer, $18,000; assistant treasurer, $12,000; secretary, $15,000; assistant secretary, $12,000; and Washington representative, $8,600. Previous to 1942, it had been the habit of this corporation to increase salaries when it had a successful year. But no increase was permitted at this period, "according to law." (R. 37.)

Gilfillan Bros., Inc., was incorporated in 1917, and was in active business in and around Los Angeles. It had been in the business of manufacturing household radios since 1922. It also manufactured electronic equipment, radar and aircraft mechanical parts. In 1941 an estimated 75 per cent of its business was military work and 25 per cent related to commercial radios. At the beginning of 1942 it was manufacturing radios and aircraft precision parts. For the fiscal year ended May 31, 1943, it had net sales after renegotiation in the amount of $3,495,822.57. It had a net profit, after renegotiation and before payment of taxes, in the amount of $306,949.64. The salaries of its officers for this period were as follows: President, $32,432.40; vice president, $14,999.92; vice president, $14,999.92; J. G. Gilfillan (office undesignated) $10,500; vice president, $8,400.08; secretary-treasurer, $4,252.22. (R. 38.)

All of these officers except the vice president, whose salary was $8,400.08, were stockholders. The salary of the president had remained the same for a period of 15 or 20 years. The salary of its engineers for this period were as follows: Chief engineer, $15,000; assistant engineer, $12,000; engineer, $10,000. Its total number of employees increased in 1943 from 750 to 1,000 at the end of the year. The officers' salaries of Gilfillan Bros., Inc., were "frozen during the war years." (R. 38.)

The Commissioner found that a reasonable allowance for salary for Hoffman for 1943 was $25,000, rather than $63,613.20, and that a reasonable allowance for salary for W. S. Harmon, taxpayer's vice president, was $12,000 instead of $22,171.08. Accordingly, he assessed a deficiency in income tax, declared value excess profits tax, and excess profits tax for 1943 in the amounts of $3,279.24, $1,334.34 and $51,331.77 respectively. (R. 21.) The Tax Court found that a reasonable salary for Hoffman was $40,000 and that a reasonable salary for Harmon was $22,171.08. (R. 21-46.) The reasonability of Harmon's salary is not in issue on this appeal.

The Tax Court reassessed taxpayer's deficiency for the taxable year 1943 as follows: Income tax, $3,279.24; excess profits tax, $32,262.38; declared value excess profits tax, none. (R. 47.)

Thereafter, taxpayer petitioned this Court for review of the Tax Court's decision. (R. 551-555.)

SUMMARY OF ARGUMENT

The issue involved must be determined upon the peculiar facts of each individual case and the burden of showing reasonableness is on taxpayer.

Any form of contingent compensation is subject to scrutiny. And where the original contract for contingent compensation is not a fair and free bargain between employer and employee, it is not entitled under the Regulations to permanent protection from scrutiny. In view of the evidence, it can not be said that the taxpayer freely bargained for Hoffman's services. Opinion evidence that the contract was reasonable does not belie this conclusion.

In any event, the Tax Court properly examined into circumstances current in the taxable year, for it can not be said that a contract once reasonable is an open invitation to unreasonable compensation thereunder in later years. Such a conclusion would abrogate the statute. Accordingly, evidence that taxpayer's profits were in great measure increased by the accident of the advent of war, that Hoffman's duties and responsibilities did not increase commensurately with his increase in salary, and that Hoffman's compensation for the taxable year was out of line with the standard shown to prevail in the industry supports the Tax Court's ultimate finding as to a reasonable allowance for Hoffman's salary.

ARGUMENT

I

Considering the Circumstances Under Which It Was Executed, Hoffman's Contingent Compensation Contract Was Not Beyond Scrutiny Under the Regulations

In computing net income subject to income, declared value excess profits, and excess profits taxes, the corporate taxpayer is entitled as a matter of grace to certain deductions from gross income, among them the deduction provided in Section 23 (a) (1) (A) of the Internal Revenue Code (Appendix, *infra*). Therein provision is made for the deduction of the ordinary and necessary expenses paid or incurred in the taxable year in the carrying on of a business, "including a reasonable allowance for salaries or other compensation for personal services actually rendered." The single issue herein lies in the application of the quoted provision to the facts at bar.

Treasury Regulations 111, Section 29.23 (a)-6 (Appendix, *infra*), provide that the test of deductibility is whether the payments in question are reasonable and are in fact payments purely for services. The Regulations contemplate that employment contracts may embody contingencies which will affect the amounts paid from period to period, and it is implicit that reasonable contingent payments may exceed what would otherwise be a reasonable compensation in given circumstances. But Section 29.23 (a)-6 (3) provides further that—

> In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances.

Taxpayer's position is not that the amount of \$63,612.20 rather than \$40,000 is a reasonable salary for Hoffman for the taxable year, but that as a matter of law the full compensation paid him must be allowed as a deduction because it was paid pursuant to a pre-existing contract which was in itself fair and reasonable under the circumstances existing at the time of its execution. Secondly, taxpayer contends that payments to Hoffman represent reasonable compensation even if events subsequent to the execution of the salary contract are to be taken into account.

Taxpayer relies on language in subsection (3) of the pertinent Regulations which provides that—

> The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

Upon this language he bases his premise that the full deduction must be allowed as a matter of law. The Tax Court, however, and rightly we believe, considered this language of the Regulations limited by the language of the statute, the statute being of paramount importance and requiring that compensation for any taxable year must in any event satisfy the requirement of reasonability. Accordingly, the Tax Court not only examined the original execution of Hoffman's salary contract as to which it found there was not (R. 44)—

> The free bargaining and arm's length transaction, between a corporation and a proposed employee for services on a contingent basis, with which, under the regulation, there should not be interference,

but it also examined the circumstances existing at the time the deduction was sought.[1] The Tax Court held that conditions of the business had radically changed between the time the compensation contract was entered into and the taxable year. The court attributed a large part of taxpayer's greatly increased volume of business to the war emergency and could find no justification for the tremendous increase in Hoffman's compensation for 1943 over 1942.

The Commissioner's position is similar to that expressed in the Tax Court's opinion that (1) the original contract of employment was not the result of a free bargain between employer and individual, and that (2) in any event circumstances present in 1943 did not justify the high salary paid Hoffman.

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[1] In this regard the Tax Court did not ignore the ruling of *Austin* v. *United States,* 28 F. 2d 677 (C.A. 5th), nor its own ruling in *California Vegetable Concentrates, Inc.* v. *Commissioner,* 10 T. C. 1158, as taxpayer contends. The opinion below is entirely consistent with these two cases.

As Judge Dobie pointed out in *Miller Mfg. Co.* v. *Commissioner,* 149 F. 2d 421, 423 (C. A. 4th):

> It is well settled that the question of what constitutes, for the tax deduction here in issue, reasonable compensation to a specific officer of a corporation, is essentially a question of fact, to be determined by the peculiar facts and circumstances in each particular case. * * * These facts and circumstances vary so widely that each corporate tub must more or less stand upon its own bottom.

Accord: *Miles-Conley Co.* v. *Commissioner* (C.A. 4th), decided April 2, 1949 (1949 P-H, par. 72,422); *Doernbecher Mfg. Co.* v. *Commissioner,* 95 F. 2d 296 (C.A. 9th); *Sunset Scavenger Co.* v. *Commissioner,* 84 F. 2d 454 (C.A. 9th); *General Water Heater Corp.* v. *Commissioner,* 42 F. 2d 419 (C.A. 9th). It is, moreover, the taxpayer's burden to make out his case by clear and convincing evidence, for the Commissioner's determination as to reasonability is presumptively correct. *Botany Mills* v. *United States,* 278 U. S. 282; *Patton* v. *Commissioner,* 168 F. 2d 28 (C.A. 6th); *Clinton Co.* v. *Commissioner,* 159 F. 2d 102 (C.A. 7th). As it is empowered to do, the Tax Court found the Commissioner's allowance insufficient but the taxpayer's demand too great. Its findings, failing taxpayer's showing that they are clearly erroneous, must stand.

The pertinent provisions of the Regulations subject any form of contingent compensation to scrutiny. Generally—but only generally—a deduction will be allowed for contingent payments if they are made pursuant to a free bargain between the employer and the individual made before the services are rendered, "not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual." This brand of fair bargain is not present in the case at bar. Admittedly, taxpayer was hardly in a position to employ Hoffman on a fixed compensation basis in December 1941. Taxpayer was hardly in a position to employ any one, on whatever basis. Admittedly, taxpayer was in poor financial condition, its reputation in the industry bad. Admittedly several witnesses testified that the contingent compensation contract was fair and equitable to the corporation. These facts do not compel the conclusion that here was a free bargain between employer and employee.

In point of fact, the employer never had an opportunity to bargain for itself. Hoffman's bargain for a 50 per cent stock interest, which would give him an appreciable voice in the company, and his bargain for contingent compensation was in effect made before the corporation ever commenced to bargain for his services. Such was his agreement with Douglas and Davidge. It is a fair inference from the evidence that at the time the corporation, through its directors, contracted for Hoffman's employment at the board meeting of December 4, 1941, each director present knew of the pending negotiations by Hoffman to purchase the outstanding stock of taxpayer. The approval of Hoffman's contract by Penney and Fleming therefore has little significance. They knew full well that the taxpayer was about to change hands, apparently upon terms agreeable to all. It would be only natural that Fleming and Penney would go along with Hoffman's plans for the future rather than queer the stock purchase. The Douglas-Davidge ratification of the agreement was no more than their formal approval of the plans they had already made for taxpayer without its knowledge.

Hoffman's contract not only was foisted upon the corporation, but it was clearly a contract formed with his, Davidge's, and Douglas' interests primarily in mind. The taxpayer as a corporation did not enter into consideration of the bargain. This hardly constituted an arm's length transaction.

Taxpayer lays great emphasis on the testimony of outsiders that the contingent contract was fair and equitable.[2] This testimony is entitled to consideration by the Tax Court and may not arbitrarily be disregarded for it is relevant, but such evidence is not binding upon the court which may exercise its own independent judgment in determining a reasonable allowance for services. *In re Rae's Estate,* 147 F. 2d 204 (C. A. 3d); *E. Wagner & Son* v. *Commissioner,* 93 F. 2d 816 (C. A. 9th). These cases are not inconsistent with *Roth Office Equipment Co.* v. *Gallagher,* 172 F. 2d 452 (C. A. 6th), cited by taxpayer. Taxpayer speaks in its brief as if there were no evidence as to the reasonability of the contingent compensation contract except the testimony of three witnesses. This is not the case. As has been shown, other facts and the inferences to be drawn therefrom contradict these three witnesses, or at least subtract from the weight to be given their testimony. The contract was not entered into pursuant to a free bargain. If it was reasonable at the time, its reasonability was accidental, and in any event it was not such a free bargain as is entitled to permanent protection under the Regulations if any contract would be so entitled.

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[2] Taxpayer stresses the fact that Gilfillan was called originally as a witness for the Commissioner. (Br. 10.) When he testified as to the reasonability of Hoffman's contract, he had been expressly made taxpayer's witness. (R. 322.)

II

In Any Event, the Tax Court Properly Examined the Contract in the Light of Current Facts and Determined Reasonable Compensation, for to Be Deductible Within the Code Compensation Payments Must Be Reasonable Under All the Circumstances

Whether or not the original contract was a fair, equitable, and reasonable one, it could not sanctify Hoffman's compensation in all circumstances. As the Regulations provide, in any event the compensation, to be a deductible expense, must be reasonable under all the circumstances. It is well settled that the Tax Court may take into account in assessing reasonability of compensation the abnormal growth of businesses as a result of our national defense, Lend-Lease, and war programs, and accordingly disallow excessive salaries paid out of those profits. *Locke Machine Co.* v. *Commissioner,* 168 F. 2d 21 (C. A. 6th), certiorari denied, 335 U. S. 861; *Wood Roadmixer Co.* v. *Commissioner,* 8 T. C. 247; *Hewitt Rubber Co.* v. *Commissioner,* decided November 28, 1947 (1947 P-H T. C. Memorandum Decisions, par. 47,317); *Cooked Foods, Inc.* v. *Commissioner,* decided July 25, 1947 (1947 P-H T. C. Memorandum Decisions, par. 47,223). Cf. *Hecht* v. *United States,* 54 F. 2d 968 (Ct. Cls.), certiorari denied, 286 U. S. 560.

Even assuming that Hoffman's contract was reasonable at its inception, it is not *carte blanche* to subsequent excessive salary or deduction thereof. Taxpayer acquired no vested right to deduct unreasonable salary payments; prior policy or contract is not conclusive of reasonability. If taxpayer were to be allowed because of long-standing policy to deduct inflated salaries drawn against bloated wartime profits, then the requirement that to be deductible all salary payments must be necessary, ordinary, and reasonable has been abrogated. *Locke Machine Co.* v. *Commissioner, supra.*

See also *Botany Mills* v. *United States, supra; Long Island Drug Co.* v. *Commissioner,* 111 F. 2d 593 (C. A. 2d), certiorari denied, 311 U. S. 680; *Hecht* v. *United States, supra.* Cf. *Interstate Transit Lines* v. *Commissioner,* 319 U. S. 590. Necessarily, although more than normal amounts may be paid under a contingent contract, payments can not be allowed beyond reason to absurd lengths.

It is highly material that the advent of the war contributed greatly to taxpayer's business growth. This is readily apparent from the amount of war work it did in 1942 and 1943. There is no indication that Hoffman's work load increased in 1943 commensurately with the salary taxpayer seeks to deduct for him.[3] Perhaps the Tax Court can not properly suggest (Cf. R. 45) that contrariwise his work decreased. At any rate the Tax Court did not reach a conclusion contrary to taxpayer's contention that "Hoffman worked hard and rendered valuable services during 1943." (Br. 27.) Hoffman's duties increased administratively in 1943, but this is no indication that they increased greatly over-all. In fact, under military orders administrative work may well have decreased as it did in other firms. (R. 326-327.) Moreover, the court allowed for some increase in Hoffman's duties, such as would necessarily result from a large increase in sales volume, by awarding him $40,000 which is considerably more than his salary for 1942.

Taxpayer places great reliance upon the conclusion by war contracts renegotiation authorities that Hoffman's compensation was reasonable. (Br. 29.) This conclusion has little value in a tax proceeding. The renegotiation legislation had in mind not an orderly

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[3] In this connection, it may be noted that long hours and hard work do not of themselves compel a conclusion of reasonability. *Atlas Plaster & Fuel Co.* v. *Commissioner,* 55 F. 2d 802 (C.A. 6th).

system of providing revenue but its aim was to keep profits and therefore Government costs to a minimum, both to save unnecessary expense to the war program and to forestall snowballing inflation. Moreover, the provisions of the Renegotiation Act cited by taxpayer (Br. 30) specifically state that costs shall not necessarily be allowed because they may be allowed for tax purposes. It follows that the reverse is true. At best, the acceptance of the cost of Hoffman's salary is merely evidence of reasonableness which is not alone sufficient to sustain taxpayer's burden.

In substance, taxpayer argues that because the bank from which it secured a loan did not restrict contingent payments to Hoffman the bank approved them. (Br. 31.) But this thesis is weakened by the bank's insistence on restricting salaries which any officer or director might draw in excess of the contingent payments. Taxpayer's failure to pay dividends may be partially explained by restrictions in the same loan agreement. (Br. 31.) But this does not explain taxpayer's failure to request permission to declare dividends (R. 168-169) nor Hoffman's failure as principal stockholder and trustee for Davidge and Douglas to demand them.

There is no reason for taxpayer to feel self-conscious about the fact that it profited greatly from wartime activity (See Br. 34), nor greatly to stress its nobility of contribution and temporary loss of peacetime business. No one is classifying taxpayer's war record as a "detrimental factor in this proceeding." (Br. 36.) But likewise taxpayer's war record and activity can not be considered an open invitation to abnormal profits, nor abnormal deductions.[4]

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[4] It is not unworthy of note that two Gilfillan employees voluntarily sought flat salary rates of $15,000 in the face of war profits, when their contingent salary rate would have risen to $50,000. (R. 338.)

Taxpayer contends that the rule of the *Roth* case, *supra*, is that economic conditions brought on by the war are not a factor in establishing unreasonableness. (Br. 36.) This conclusion is inconsistent with cases cited, *supra,* and with the passages taxpayer quotes from the very same case (Br. 36), to the effect that increased profits due to war activity do not "alone" establish unreasonableness where work and responsibility have increased. But economic conditions indubitably are a factor to be considered in assessing reasonability.

It may be noted in conclusion that the Tax Court's findings with respect to a reasonable salary allowance for Hoffman far more approximate the standard in the industry than the excessive amount taxpayer seeks to claim as a deduction. (R. 37-38.)

CONCLUSION

The decision of the Tax Court is in accordance with law and its findings are not clearly erroneous. Therefore, it should be affirmed.

Respectfully submitted,

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May, 1949.

APPENDIX

Internal Revenue Code:

SEC. 23 [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798].

(a) *Expenses.*—

(1) *Trade or Business Expenses.*—

(A) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in pursuit of a trade of business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(26 U. S. C. 1946 ed., Sec. 23.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.23(a)-6. *Compensation for Personal Services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of serv-

ices, is not deductible. (*a*) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payment correspond or bear a close relationship to the stock holdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. (*b*) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is in general just to assume that reasonable and true compensation is only

such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

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